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# Selected Antitrust Aspects of Trademark Franchising

By EDWARD M. STEUTERMANN\*

## INTRODUCTION

From the franchisor's viewpoint, the franchise system enables a small or medium-sized company to exploit regional and national markets which would otherwise be inaccessible to the franchisor because of capital requirements. In a recent hearing before the Senate Select Committee on Small Business, it was reported that there are approximately 1,200 franchisors in the United States with between 400,000 and 670,000 franchisees doing a total business between 90 and 100 billions of dollars each year. Moreover, these figures do not include some 33,000 franchise automobile dealers or the estimated 225,000 retail service station dealers who can be included as franchisees.<sup>1</sup>

While there may be legitimate questions as to the motives of some franchisors, the franchise system has undoubtedly provided numerous worthwhile economic and social benefits. For example, it can be asserted with considerable conviction that if there were no franchise systems available, the sources for the goods and services distributed in this country would be comprised primarily of very large vertically integrated concerns or a large number of economically weak, local distributors. Thus, assuming that there are economic benefits to be derived from a marketing system which includes numerous competing units at the retail level, the franchise system provides means for increasing the number of competing units while also providing means for local entrepreneurs to operate franchise units which can compete effectively with outlets of large vertically integrated suppliers. It has been

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<sup>1</sup> BUSINESS WEEK, January 23, 1970.

noted that franchising has been successful, in part, because it permits the franchisee and the franchisor to combine the advantages of individual ownership with many of the efficiencies of large scale vertically integrated operations,<sup>2</sup> and provides a means for individuals with limited capital to become successful businessmen when they would otherwise remain employees.

### FRANCHISE DISTRIBUTION

The term franchising is, in its broadest terms, indiscriminately applied to different arrangements used in the distribution of goods and services to the ultimate consumer. The most common use of the term refers to the distribution of goods or services in connection with a trademark owned by a franchisor-licensor where the franchisee-licensee distributes the goods or services pursuant to an agreement with the franchisor-licensor.<sup>3</sup> In one such arrangement, the franchisee does business under the name and in accordance with the style and format of the franchisor. Depending on the goods or services involved, these franchise agreements may also provide for the franchisee to manufacture goods for resale under the trademark and in accordance with the specifications of the franchisor. The product manufactured by the franchisee, for example hamburgers, ice cream, or soft drinks, may be offered for sale in a standard, uniform manner through standardized outlets which are planned, developed, and supervised by the franchisor. The other broad category of franchising includes arrangements in which the manufacturer sells a trademarked product to a distributor for resale through the distributor's own independent outlet and under the distributor's own name. In such arrangements the franchisor provides certain inducements for the franchisee to agree to distribute the products. For example, the franchisor may agree with the franchisee that he will refrain from appointing other distributors in the defined area in which the franchisee or distributor does business. Franchise agreements are also used to offer services, and in such arrangements the franchisee may provide the services under the franchisor's trademark in

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<sup>2</sup> *Hearings on Distribution Problems Affecting Small Business*, S. Res. 40, Before the Subcomm. on Antitrust and Monopoly of the Senate Comm. on the Judiciary, 89th Cong., 1st Sess., pt. 1, at 8 (1965).

<sup>3</sup> See *Susser v. Carvel Corp.*, 332 F.2d 505, 508 (2d Cir. 1964).

accordance with the procedures, specifications and format of the franchisor.

In franchise contracts where a trademark is licensed to, and used by a franchisee, whether the franchisee does business under the style and format of the franchisor or not, the franchisee relies on the goodwill previously established in the trademark. Thus, all franchisees of the trademark have a common interest in protection of this goodwill. In addition to this vested interest in continued goodwill of the trademark, the franchisor likewise has a statutory obligation<sup>4</sup> to assure the continuing quality of goods or services provided under the trademark, as hereinafter discussed. Accordingly, trademark franchise agreements commonly impose certain restraints on the methods and means by which franchisees conduct their business. Some such restraints are ultimately determined to be legitimate<sup>5</sup> while other such restraints are frequently found to be in direct conflict with the objectives and purposes of the Antitrust Laws.<sup>6</sup>

From the standpoint of a business organization, the trademark franchise agreements where the franchisor licenses the franchisee to follow the franchisor's standard method of doing business and the franchisee does business in the name of the franchisor fall somewhere between the ordinary distribution system of independent retail outlets and a completely vertically integrated distribution system where all levels of manufacture and distribution are under common ownership. Trademark franchise systems can therefore be described as an arrangement or attempt by a franchisor to duplicate the advantages of a fully integrated manufacturing and distribution system without the necessity of providing the capital to establish such a system. As previously described, in a trademark franchise agreement, the trademark owner must maintain a degree of control over operation of the individual franchise outlets. Necessarily, the franchisee sacrifices a degree of independence because of the franchisor's need to maintain control over the necessary aspects of operation of the individual retail outlet and the common interest all franchisees have in continued goodwill of the franchise system. In a franchise

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<sup>4</sup> Lanham Act, 15 U.S.C. §§ 1051 *et. seq.* (1970).

<sup>5</sup> *Susser v. Carvel Corp.*, 332 F.2d 505 (2d Cir. 1964).

<sup>6</sup> *Atlantic Refining Co. v. Fed. Trade Comm'n*, 381 U.S. 357 (1965).

system where the franchisor merely agrees to sell his trademarked products to a designated exclusive distributor in a specific area, the franchisor may have a diminished legitimate interest in the methods by which the franchisee conducts his business. This is especially true under those arrangements where the franchisee does not operate under the name of the franchisor. In general, legitimate restraints on the operations of a franchisee relate to those restraints which are reasonably ancillary to the maintenance of control and uniformity of quality, ethical standards, and successful management of franchise locations, as well as fulfilling the trademark owner's statutory obligation with respect to maintaining the quality and uniformity of goods or services distributed under the trademark. The legitimacy of restraints on the franchisee is the focal point of this article.

### *Product Franchising*

As previously noted, there are several broad categories of franchise agreements and the type selected by a particular franchisor is determined by a number of factors including the product or service to be distributed, the strength of the franchisor relative to the bargaining power of his prospective franchisees, and the competitive ability and method of operation of competitors of the franchisor.

Product franchising is used herein to describe the means for distribution of a product under the franchisor's trademark where the trademark product is manufactured by the franchisor, or under his specifications, and then distributed by franchisees through the next line of distribution,<sup>7</sup> including arrangements where the goods are consigned to such franchisees.<sup>8</sup> Product franchising is used to market a variety of goods such as automobiles, bicycles, packaged food products, etc. In most product franchising arrangements the franchisee does business under his own name although his business name may be indirectly linked with the trademarked product.

### *Trademark or Tradename Franchising*

The term trademark or tradename franchising is another sub-

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<sup>7</sup> Snap-On Tools Corp. v. Fed. Trade Comm'n, 321 F.2d 825 (1963).

<sup>8</sup> United States v. Arnold, Schwinn & Co., 388 U.S. 365 (1967).

definition of franchising as used herein. It relates to an arrangement where the franchisee is granted a license authorizing him to engage in business under the name and trademark of the franchisor where the franchisee conducts his business in the standard uniform manner prescribed by the franchisor for use with the trademark or tradename. Such trademark franchises are commonly recognized and associated with restaurants, motels, fast food establishments, and laundry and dry cleaning shops. Trademark franchising is also commonly used in connection with major manufacturing or processing operations requiring large investments of capital and the establishment of sub-distribution systems.<sup>9</sup> Such arrangements are frequently used in distribution of bakery products, soft drinks, mattresses,<sup>10</sup> and other items. In some instances such franchisors have been associations composed, at least in part, of the licensees or franchisees.

Both trademark licensing franchise arrangements and product franchising arrangements are closely related. However, while they bear resemblance in many respects and encounter very similar problems, there are certain antitrust questions which arise from, and are affected adversely or favorably by, the existence of the trademark license agreement which are not encountered in other distribution systems. The following discussion is directed to certain antitrust questions which occur in trademark franchising and product franchising and the differences or advantages, if any, accruing by the existence of the trademark.

#### STATUTORY REGULATION

Congress has enacted three major statutes which affect and regulate competition in the conduct of business in interstate or foreign commerce. These statutes, the Sherman Act,<sup>11</sup> Sections 2-4 of the Clayton Act,<sup>12</sup> and Section 5 of the Federal Trade Commission Act regulate and affect the methods of doing business and competition at all functional levels from the manufacturer or trademark owner-licensor to the retail outlets.

The Sherman Act prohibits, in its broadest terms, restraints

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<sup>9</sup> Pollock, *Antitrust Problems in Franchising*, 15 N.Y.L.F. 106 (1969).

<sup>10</sup> *United States v. Sealy, Inc.*, 388 U.S. 350 (1966).

<sup>11</sup> 15 U.S.C. §§ 1-2 (1970).

<sup>12</sup> 15 U.S.C. §§ 13-15 (1970).

which unreasonably affect the flow of interstate or foreign commerce. Section 1 of the Act condemns collective conduct in restraint of trade by prohibiting every contract, combination, or conspiracy in restraint of trade. Section 2, in general, prohibits both joint and individual efforts toward monopoly in "any part of the trade or commerce among the several states or with foreign nations."

The requisite affect on competition is only minimal as noted by the Supreme Court in *United States v. Frankfort Distilleries*,<sup>13</sup> "[t]he fact that the ultimate object of the conspiracy charged was the fixing or maintenance of local retail prices, does not of itself remove it from the scope of the Sherman Act. . . ." With respect to franchisors, the Act prohibits, for example, suppliers or franchisors from engaging jointly or severally in restraint of trade (*e.g.*, price fixing, market allocations, boycotts, or other devices, which unreasonably restrain franchisees in the conduct of their business with franchisors, other franchisees, or others). The Act likewise applies to franchisees in that it prohibits them from indulging in comparable restraints of trade (*e.g.*, one or more franchisees may not seek to monopolize a local market where the effect of the action affects commerce across state boundaries). Moreover, the franchisees may not conspire, combine, or otherwise agree to engage in concerted activities to force the franchisor to engage in any practices which have an adverse affect on competition.

The Clayton Act of 1914, as amended by the Robinson-Patman Act of 1936,<sup>14</sup> prohibits certain limited forms of restraint on competition. It applies only if the prohibited conduct occurred in the course of interstate commerce; the Sherman Act requires only an effect on interstate commerce. Therefore, the proof of jurisdiction under the Clayton Act, Sections 2 and 3, is somewhat more difficult in cases where the complaint is based on conditions limited mainly to local markets. For purposes of this discussion, only Section 3 of the Clayton Act<sup>15</sup> is considered, but it should be noted that Section 2 of the Act,<sup>16</sup> as amended by the Robinson-Patman Act, dealing with price discrimination between purchasers

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<sup>13</sup> 324 U.S. 293, 298 (1945).

<sup>14</sup> 49 Stat. 1526 (1936).

<sup>15</sup> 15 U.S.C. § 15 (1970).

<sup>16</sup> 15 U.S.C. § 14 (1970).

of goods from the same seller, can apply to the franchise relationships where the franchisor supplies goods to different franchisees at different prices so that the effect of the price discrimination may be to substantially lessen competition in a line of commerce.

Section 3 of the Clayton Act is directed against the use of exclusive dealing arrangements, total requirement contracts, and so-called "tying arrangements" which provide that goods will be made available only on the conditions that other, different, goods are also purchased from the same seller. This section prohibits such conduct where the probable effect "may be" to substantially lessen competition or tend to create a monopoly in a line of commerce. Thus, the actions under consideration need not actually restrain trade but need only tend to substantially restrain trade.

Section 4 of the Clayton Act<sup>17</sup> provides that any person "injured in his business or property by reason of anything forbidden in the Antitrust Laws has a private right of action for treble damages plus the cost of the suit including a reasonable attorney's fee." Section 4 has been interpreted to apply to the Sherman Act and to Section 3 of the Clayton Act.<sup>18</sup>

The Federal Trade Commission Act of 1914, while not strictly an antitrust law is an important trade regulation statute. In substance the statute is a catch-all prohibition of unfair methods of competition or deceptive actions or practices. It is basically regulatory in nature and vests exclusive jurisdiction in the Federal Trade Commission established thereby. The unfair methods of competition prohibited by the Act include, but are not limited to, the acts or practices prohibited by the Sherman Act, and the Clayton Act, as well as incipient violations of these Acts, and other deceptive acts or practices. In this regard the Federal Trade Commission Act has been interpreted to give the Federal Trade Commission a zone of exclusive authority to restrain arrangements and practices which threaten to develop into violations of the Sherman Act or the Clayton Act.<sup>19</sup>

#### THE FRANCHISE PROGRAM

Franchisors impose controls on franchisees for at least two essential reasons. First, a franchisor believes, usually with justifi-

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<sup>17</sup> 15 U.S.C. § 15 (1970).

<sup>18</sup> *Nashville Milk Co. v. Carnation Co.*, 355 U.S. 373 (1958).

<sup>19</sup> *Fed. Trade Comm'n v. Brown Shoe Co., Inc.*, 384 U.S. 316 (1966).



cation supported in part by the statutory requirements of the Lanham Act,<sup>20</sup> that he must impose certain restrictions to protect his trademark and the goodwill of his franchise system. Such restrictions take various forms including specialization of products the franchisee can sell at the franchise outlet, sources of supply of raw materials for the trademarked item, and restrictions on other types of goods to be sold by the franchisee. Second, franchisors impose controls on their licensed franchisees to sustain the desirability and value of the franchise. Such controls include assigning franchisees particularly defined areas in return for which the franchisor agrees that he will not grant other franchisees an opportunity to do business in the area. The foregoing and other restrictions may or may not be legal depending upon the surrounding circumstances.

The practice of imposing restrictions on the conduct of business is generally considered to have begun with agreements not to compete, imposed by the buyer on the seller of a business as a covenant in the sale agreement. Subsequently, limitations on granting a trademark or tradename in connection with the sale of a business were included in sales agreements because the transfer of the trademark or tradename was understood to be an important factor in the transfer of the associated business. Acceptance of this transfer of trademark and tradename rights with the sale of the business led to the idea of granting a license for use of a trademark and manufacture and sale of products without the sale of the original business itself. In such licensing activities certain obligations were imposed on the use of the trademark to prevent deception in connection with the licensed trademark. Basically, the restrictions and obligations have been carried over by the Lanham Act.<sup>21</sup> The obligations include the requirement that the trademark owner maintain adequate control over use of the trademark to assure minimum standards of quality or uniformity; failure to do so can lead to loss of the trademark.<sup>22</sup> Extension of this concept depends on the transfer of trademark rights to agreements to license manufacturers or sellers in areas where the trademark owner could not, or did not intend to, expand

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<sup>20</sup> 15 U.S.C. § 1064 (1970).

<sup>21</sup> 15 U.S.C. §§ 1055, 1064 (1970).

<sup>22</sup> 15 U.S.C. § 1064 (1970).

his business, so that the goodwill of the mark is extended without significant capital outlay by the trademark owner. Thus, while the trademark was initially a designation of source or origin of the product it has later come to be recognized as an assurance of quality, regardless of the actual source or origin of the product.

In most franchise agreements of the type discussed, the trademark or tradename license and the associated goodwill are among the primary assets of the franchise package. This is because the public buys the franchise product or service in response to the familiar trademark. The value of this trademark in commercial activity has been recognized by the courts. A typical judicial attitude is illustrated by the statement of Mr. Justice Frankfurter in *Mishawaka Rubber and Woolen Manufacturing Co. v. S.S. Kresge*, although a pre-Lanham Act case, still accurately describes the character and effect of trademarks:

The protection of trademarks is the law's recognition of the psychological function of symbols. If it is true that we live by symbols, it is no less true that we purchase goods by them. A trademark is a merchandising shortcut which induces the purchaser to select what he wants or what he has been led to believe he wants. The owner of a mark exploits his human propensity by making every effort to impregnate the atmosphere of the market with the drawing power of a congenial symbol. Whatever the means employed, the aim is the same—to convey through the mark, in the minds of potential customers, the desirability of a commodity upon which it appears. Once it is attained, the trademark owner has something of value.<sup>23</sup>

The Lanham Act<sup>24</sup> codified much of the common law of trademark licensing. The Act expressly provides for trademark licensing by providing that the registered mark may be used by an "unrelated company" and that such use will inure to the benefit of the registrant without adversely affecting the validity of the mark so long as the registrant has taken steps to assure that the mark is not "used in a manner to deceive the public."<sup>25</sup> The Lanham Act defines a related company as one which legitimately controls or is controlled with respect to the nature and quality of

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<sup>23</sup> 316 U.S. 203, 205 (1942).

<sup>24</sup> See note 4 *supra*.

<sup>25</sup> 15 U.S.C. § 1127 (1970).

the goods and services in connection with which the mark is used.<sup>26</sup> The Act further provides for loss of exclusive right to use the mark, *inter alia*, if the mark is used to violate the antitrust laws of the United States or becomes descriptive of the goods sold under the trademark.<sup>27</sup> Thus, the law imposes two difficult and sometimes conflicting trademark limitations on the licensor. He must control the use of the mark by his licensees to prevent deception of the public, while on the other hand, the restraints imposed cannot be unreasonably restrictive. If he goes too far in either direction, he risks the loss of exclusive rights in his trademark.

### CONTROL TECHNIQUES

Trademark franchises employ various control techniques to meet the requirements of trademark protection,<sup>28</sup> *e.g.* uniformity of style, appearance, quality and value, as well as maintenance of the desirability and profitability of the overall franchise operation. An example of this is where a franchisee conducts a retail business under a franchisor's name. In this situation the law recognizes that within limits, the franchisor's efforts to protect the trademark will undoubtedly require more detailed control over the franchisee's business choices than in the case of mere resale of a vendee's product.<sup>29</sup> Where the franchisee conducts his business in his own name or style of business, the extent of permissible control of the franchisor is correspondingly diminished.

Alleged antitrust violations with respect to the franchisor-franchisee relationship are almost invariably based on the restrictions imposed by the franchisor. The allegation is usually to the effect that the restriction is a *per se* violation of the antitrust laws. A *per se* violation means that the practice cannot be justified regardless of the franchisor's reason for imposing the condition.<sup>30</sup> However, in cases where restraint is not unreasonable *per se*, but is merely a potentially unreasonable restraint of trade, the franchisor can avoid liability by proving that the restriction imposed is ancillary to a legitimate business purpose and that the restriction does not unreasonably restrain trade.

<sup>26</sup> *Id.*

<sup>27</sup> 15 U.S.C. § 1115 (1970).

<sup>28</sup> *Susser v. Carvel*, 332 F.2d 505 (2d Cir. 1964).

<sup>29</sup> *United States v. Sealy*, 388 U.S. 350 (1966).

<sup>30</sup> *Standard Oil Co. of New Jersey v. United States*, 221 U.S. 1 (1911).

The most common restraints imposed by franchisors are directed to:

1. Customers to whom the franchisee may sell;
2. The territory in which the franchisee may market the trademark licensed products or otherwise do business;
3. The products which the franchisee may handle at the franchise location including limitations on those which he cannot sell;
4. Sources of supply for raw materials and raw material and product specification; and,
5. Restrictions affecting the price of products or services distributed by the franchisee.

If the restraint is not illegal *per se*, then several factors are considered in determining the legality of such restraint. Initially a determination can be made as to whether the restraint is vertically imposed by the franchisor, who is independent of the franchisees, or whether the restraint is imposed as part of a horizontal arrangement imposed by collaboration among its franchisees and whether the franchisor is under control of, or acting on behalf of certain of the franchisees. While the particular restraint may not be illegal, *per se*, illegality may be found if the source of the restraint is horizontal pressure and the purpose of the restraint is to diminish competition. If the restraint is vertically imposed rather than horizontally imposed and considered not illegal *per se*, legality may then be determined by the justification the franchisor provides for the restraint. In order to prevail, the franchisee may have the burden of showing why other less confining restraints could not have been used to achieve the desired effect, as well as at least an intention on the part of the franchisor to achieve some legitimate ancillary goal. In a recent address the Commissioner of the Federal Trade Commission, Everett MacIntyre, outlined three factors which should be considered in determining the legality of restraints or controls on franchisees:

1. Whether the franchise program has as its main purpose the establishment of a group of franchisees who are compelled to purchase products from the franchisor, or sources designated by the franchisor, many times at prices above market and that such a system might by itself constitute an unfair

method of competition of violation of Section 5 of the Federal Trade Commission Act;

2. If a franchise program requires a franchisee to submit to control by the franchisor then such controls must be justified and justification for the controls must be carefully considered, and when the franchise agreements relate to trademark licenses where the franchisee manufactures the trademarked product, the franchisor may be required to justify the quality controls it imposes on the franchisee even though the Lanham Act has been held to require the owner to exercise control over operations of the related companies using its trademarks; and,
3. The competitive impact of controls are to be considered such as the effect of the controls on the freedom of the purchaser (*i.e.* franchisee) to purchase from the open market, the size of the market, and the strength of and direct impact of the program on competitors.<sup>31</sup>

### *Resale Price Maintenance*

In certain cases franchisors find it desirable to impose resale price maintenance agreements with respect to goods or services offered in connection with trademark licensing programs. Direct imposition of these agreements is, in virtually all cases, illegal under the Sherman Act.<sup>32</sup> However, in spite of the *per se* illegality franchisors still seek to impose such arrangements, for example, in cases where the prices of the trademarked goods or services are advertised in connection with the franchise licensing program or where price uniformity is important to the image of its franchise program. However, no such foundation will support a price maintenance program, and regardless of whether it is vertically or horizontally imposed, such a program is illegal. Such inability to maintain uniform prices through franchise locations is obviously irritating to a franchisor who is in direct competition with a vertically integrated concern which is clearly free to maintain or vary retail prices at will.

In spite of the foregoing there are a few actions which seller or franchisors can assert with respect to purchasers who refuse to

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<sup>31</sup> Excerpts from Address by Everette MacIntyre, Conference of International Franchise Association, May 8, 1969, TRADE REG. REP. ¶ 50,240 (1961).

<sup>32</sup> United States v. Parke, Davis & Co., 362 U.S. 29 (1960).

maintain prices. But, such actions are of only limited effectiveness and even these limited actions inherently invite serious risk of liability. For example, in *United States v. Colgate & Co.*,<sup>33</sup> the Supreme Court upheld the right of a seller to refuse to deal with a customer who refuses to sell at a suggested price. The *Colgate* case has subsequently been narrowed and refined in a number of ways and is presently limited to a simple refusal to sell without evidence of pressure on the customer to conform to the seller's price maintenance program. In *United States v. Parke, Davis & Co.*,<sup>34</sup> the Court found that an illegal combination to fix prices existed where the seller suggests resale prices and secures compliance by means in addition to the "mere announcement" of his policy and a refusal to deal with distributors who sold to retail outlets that cut prices, thereby creating pressure to conform. The Court, in view of *Colgate* found the practice to be illegal. The *Colgate* decision was again considered in *Interphoto Corp. v. Minolta Corp.*,<sup>35</sup> where the trial court said:

Today, a manufacturer can avail himself of the *Colgate* doctrine only where he suggests a resale price and does not make any attempts to enforce his suggestion, and he then refuses to sell to the dissident distributors. Anything beyond this act of 'Doric simplicity' is more than a unilateral refusal to deal and constitutes a *per se* violation of the antitrust laws.<sup>36</sup>

In *Albrecht v. The Herald Company*,<sup>37</sup> the Supreme Court again confirmed the *per se* illegality of enforced retail maintenance programs. In this case the Court found a combination, rather than a contract or conspiracy, to restrain trade where a newspaper route carrier purchased his route on an agreement to purchase newspapers at wholesale and sell over a specified route at retail. The defendant publisher had objected to a unilateral unauthorized price increase by the plaintiff carrier. When the plaintiff refused to change his position, or his price, the defendant contracted with a private firm to solicit the route and deliver papers at the lower price suggested by the defendant. The defendant continued

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<sup>33</sup> 250 U.S. 300 (1918).

<sup>34</sup> 362 U.S. 29 (1960).

<sup>35</sup> 295 F.Supp. 711 (S.D.N.Y., 1969).

<sup>36</sup> *Id.* at 719.

<sup>37</sup> 390 U.S. 145 (1967).

to deal with the plaintiff and to negotiate with him, but also advised the plaintiff that he could be terminated if he did not conform to defendant's resale price maintenance program. The Court found that there was a combination rather than the usual conspiracy because the defendant had directed the activities of those with which it was associated rather than conspiring with them to accomplish a common purpose. Since it is more difficult to prove a conspiracy than it is to prove a combination, the decision can be taken to indicate that a lesser degree of proof may be required of the plaintiff in future price fixing cases where a combination can be alleged.

Applying the foregoing to trademark franchising, it can be stated that while *Colgate* upheld the right of a seller to simply refuse to deal if the purchaser does not comply with the seller's wishes as to resale prices, in view of the subsequent cases, it is doubtful whether a franchisee can any longer even avail himself of the simple refusal to deal. This is because of the leverage which the franchisor has in relation to the franchisee. In ordinary arrangements the franchisee has generally invested a considerable amount of capital to establish the business under the name and style of the franchisor. Any suggestion that the franchisor may withdraw the right to do business under the franchised name, if the franchisee refuses to comply with a price maintenance program or other restraint of trade, would in the normal course of events have a significant impact on the franchisee and could easily be interpreted to be something in excess of the "Doric simplicity" standard set out in *Minolta*.<sup>38</sup>

A franchisor is free to maintain resale prices pursuant to a state fair trade law, but such price maintenance programs must be rigorously monitored and enforcement of the program must be even-handed or the franchisor may lose rights and privileges granted under the fair trade exemption to the antitrust laws.<sup>39</sup> Moreover, most fair trade laws prohibit fair trading of a product if the seller is in competition with his customer for the same class of consumer.<sup>40</sup> This type of provision would prevent a franchisor from operating his own retail outlets in a state where he intends

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<sup>38</sup> 295 F. Supp. 711 (S.D.N.Y. 1969).

<sup>39</sup> 15 U.S.C. § 1 (1970), 50 Stat. 693 (1937).

<sup>40</sup> 16 C.F.R. § 240.9 (1972).

to take advantage of a fair trade statute. Under the current operating methods used by most trademark franchisors where there are both franchisor-owned and independently-owned franchise operations, this undoubtedly would preclude many franchisors from adopting fair trade programs. Also, fair trade laws are under continuing attack from the Department of Justice which maintains a permanent program to urge state legislatures to repeal fair trade laws wherever they exist.

While in general, a franchisor must avoid interference with the prices charged by his franchisees, and may on occasion even be required to demonstrate affirmatively that franchisees do have a right to determine their own prices, there are means by which the franchisor can individually obtain some minimal degree of price uniformity, even though he may not be able to secure complete compliance. One method known as "pre-ticketing" has been used in distribution for resale of products manufactured by the franchisor. The franchisor suggests a retail price by affixing a label bearing a "suggested price" to the goods before shipment. The label generally carries other information about the associated products so there is some assurance that it will not be removed before sale and that the customer will see the suggested price. The Federal Trade Commission generally considers pre-ticketing to be legal as long as the price is representative of the majority of sales. This requirement places a burden on the manufacturer to maintain contact with his outlets to assure that the price ticketed is not out of date. Therefore, pre-ticketing may cause the manufacturer or licensor to follow the market price rather than lead it.

Another method of providing some price uniformity, which likewise carries material risks, involves a program followed by some franchisors who provide advertising for their franchisees. In this method, the franchisor publishes his "suggested price" in advertising copy or material. The franchisee then finds that all of the advertising material provided for use at the franchise location and all advertising material exhibited in the media to the public carries a suggested price structure and that variation from that price structure is difficult and inconvenient, particularly if his price is higher than the suggested price. In some cases the franchise agreement provides that the franchisee will be given a certain allowance for purchase of local advertising in connection



with the franchise product, but only on the condition that the franchisee feature prices acceptable to the franchisor. This practice was found to be a violation of Section 5 of the Federal Trade Commission Act.

It should be noted that neither of the foregoing methods provides a significant deterrent to price cutting. They are effective only with respect to an unauthorized increase in prices except in those states where the fair trade law allows the trademark owner to fix the price rather than merely set a minimum price.<sup>41</sup> If a franchisor is subsequently charged with an antitrust violation in connection with any of the foregoing practices, his best line of defense would, of course, be the necessity for uniform practices at the franchise locations, but such a defense is weak if he cannot support the practices as reasonably ancillary to a legitimate purpose. In the case of advertised prices some mitigation of risk may be achieved through use of a covenant in connection with the suggested advertised prices that the prices are only suggested and may be subject to local variation.

### *Territorial Location Restrictions*

Exclusive dealerships, distributorships, franchises, and territories have been attacked as illegal under the Sherman Act.<sup>42</sup> In general, however, granting an exclusive distributorship of the type where the franchisor merely agrees not to franchise anyone else in a specific area is not illegal *per se*. However, such restraints are subject to the rule of reason enunciated in *Standard Oil Company of New Jersey v. United States*,<sup>43</sup> that the Sherman Act does not prohibit all restraints of trade but does prohibit unreasonable restraints of trade. In particular, *Permalife Mufflers Company, Inc. v. International Parts Corporation*,<sup>44</sup> can be interpreted to hold that the rule of reason applies to exclusive distributorships in the absence of additional restraint. Arrangements providing exclusive territories for franchisees are of advantage to both the franchisor and the franchisee. These arrangements are favored

<sup>41</sup> S. OPPENHEIM & G. WESTON, *FEDERAL ANTITRUST LAWS* 484 (3d ed. 1968).

<sup>42</sup> *United States v. Arnold Schwinn & Company*, 388 U.S. 365 (1966).

<sup>43</sup> 221 U.S. 1, 59-62 (1911).

<sup>44</sup> 393 U.S. 194 (1967).

by franchisors because of the reduction in cost of sales resulting from the limited number of dealers with which the franchisor must deal and because it is easier to find franchisees if territories are given on an exclusive basis. The franchisee finds exclusive arrangements desirable because of the lessened intrabrand competition encountered.

The *Schwinn* case<sup>45</sup> clearly demonstrates that territorial limitations are of two general types and there is a significant difference in the legality of the two. The first type, previously discussed, involves an agreement where the franchisor merely authorizes the franchisee to do business in the defined area; the franchisor will not do business there himself, nor will he engage other franchisees in the same area so long as the franchisee exerts minimum efforts for promotion of the franchise system. The second type of territorial limitation, sometimes referred to as territorial confinement, involves significant and almost conclusive risk of illegality. It provides for the franchisor to license the franchisee to do business in the defined territory, agree he will not do business there himself, that he will not license others to do business in the defined territory, and further that the franchisor prohibits the franchisees from selling to or soliciting business from customers outside their defined areas.

*United States v. Sealy*<sup>46</sup> involved an agreement in which the franchisees agreed not to sell outside their respectively assigned territories. The agreement was found to be illegal *per se*. While the actual effect of the decision is clouded somewhat by the fact that the arrangement was also used for price-fixing purposes, it nonetheless provides little aid and comfort to those who would assert that a territorial confining type arrangement can be justified. At the very minimum the decision stands for the proposition that there are serious risks involved with restrictive territorial covenants. In a more recent case, the Supreme Court in *United States v. Schwinn*<sup>47</sup> stated that the validity of *Schwinn's* territorial and customer restrictions in connection with the sale of bicycles to distributors for resale to retail outlets depended on whether the restraints were reasonable and the reasonableness was to be

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<sup>45</sup> 388 U.S. 365 (1966).

<sup>46</sup> 338 U.S. 350 (1949).

<sup>47</sup> 388 U.S. 365 (1966).

determined by the impact of the restrictions on the market. Schwinn had imposed exclusive territorial restrictions on distributors whereby the distributors were not to resell outside the assigned territory. The Court held that:

... where the manufacturer sells a product to its distributors subject to a territorial restriction upon resale, a *per se* violation of the Sherman Act results. . . .<sup>48</sup>

From the foregoing it can be concluded that, at least within the factual circumstances encountered in the *Schwinn* arrangement, territorial restrictions on resale of products are illegal. However, there remains some support for the view that not all territorial restrictions are illegal since the Supreme Court did indicate that the initial question in *Schwinn* was directed to the reasonableness of the restraint and the impact of the restraint upon the market. More particularly the Court stated:

Under the Sherman Act, it is unreasonable *without more* for a manufacturer to seek to restrict and confine areas or persons with which an article may be traded after the manufacturer has parted with dominion over it. [emphasis added].<sup>49</sup>

The use of the term "without more" in connection with the definition of *per se* illegality leads to considerable confusion in the interpretation of the decision. Specifically, the phrase could be interpreted to mean that without additional justification the territorial restriction is illegal or could be interpreted to mean that regardless of other justifying matters or circumstances, the restriction is illegal.

The *Schwinn* case did, however, provide express approval for the practice of exclusive territorial, but not restrictive territorial, franchises under certain conditions:

A manufacturer of a product, other and equivalent brands of which are readily available in the market, may select his customers and for this purpose he may "franchise" certain of them to whom alone he will sell his goods. If the restraint stops at that point—if nothing more is involved than vertical consignment of the manufacturer's own sale of the merchan-

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<sup>48</sup> *Id.* at 379.

<sup>49</sup> *Id.*

dise to selected dealers, and if competitive products are readily available to others, the restrictions on these facts alone would not violate the Sherman Act.<sup>50</sup>

Thus, it appears that a franchisor can selectively and exclusively franchise dealers in selected areas and agree that he will not do business with others within the area or that he will not do business directly with customers in the area. He cannot, however, ordinarily limit the franchisee to that area and prohibit sales to certain classes of customers or customers outside the area. In some previous cases, *infra*, franchise agreements including certain types of territorial resale restrictions, have been found legal but the findings are clouded by the decision of the Supreme Court in *Schwinn*. Specifically, in *Sandura Co. v. Federal Trade Commission*,<sup>51</sup> the Sixth Circuit Court of Appeals upheld resale restrictions because they were found to be reasonable in view of the relative size of the franchisor and its competitors. The franchisor demonstrated that without the restrictions, he would be unable to obtain franchisees. Based on the comments of the court with respect to the decision in *White Motor Co. v. United States*,<sup>52</sup> there is some reason to believe the *Schwinn* decision,<sup>53</sup> by implication, can be interpreted to carve out a possible exception to the illegality of territorial restrictive agreements in the circumstances somewhat similar to those presented by *Sandura*. From the foregoing it could at least be argued that in the case of a franchisor competing with a large vertically integrated competitor, territorial restrictions may in some cases be justified under a "compelling and appropriate setting" as mentioned in *Schwinn*.

*Sherman v. Weber Dental Manufacturing Co.*<sup>54</sup> involved a territorial restrictions' covenant that received approval of the trial court. The sale contract for the dental equipment sold by the franchisor included a guarantee of continuing service. Because the distributor who sold the equipment was responsible for fulfilling the servicing obligations, distributors were required to restrict sales to the area which they could reasonably service. On a Motion for Summary Judgment, the court cited *Schwinn* and,

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<sup>50</sup> *Id.* at 376.

<sup>51</sup> 339 F.2d 847 (6th Cir. 1964).

<sup>52</sup> 373 U.S. 253 (1963).

<sup>53</sup> *United States v. Arnold Schwinn & Co.*, 388 U.S. 365, 373-4 (1966).

<sup>54</sup> 285 F.Supp. 114 (E.D. Pa. 1968).

without determining the legality of the arrangement, held that Summary Judgment would not be appropriate without consideration of the factual basis for the restriction. The court thereby, arguably, implied that the restriction was not illegal *per se* but could be justified as reasonably ancillary to a legitimate business purpose.

The present state of territorial restrictions in franchise operations is unclear. However, in view of the *Schwinn* finding of *per se* illegality, and the decision in *Sealy*<sup>55</sup> and *Temkin Roller Bearing Co. v. United States*,<sup>56</sup> it can be concluded that a valid trademark, without more, will not insure the legality of a territorial restriction and that at best the agreement will stand or fall on factors other than the trademark license. For example, in *Perma-life Mufflers, Inc. v. International Parts Corp.*,<sup>57</sup> the Supreme Court indicated that the franchisor was entitled to a trial on the merits to determine the legality or illegality of an agreement involving territorial and customer limitations, and whether the restraints were reasonable to protect the defendant's registered Midas trademark and service mark.

Subsequently, in *Mid-America ICEE, Inc. v. John E. Mitchell Co.*,<sup>58</sup> the trial court overruled a Motion for Summary Judgment and indicated that territorial restrictions are not illegal in trademark franchising agreements because the franchisee never receives control of the trademark which is the subject property of the license. The basis of the decision is apparently contrary to the rationale of the *Susser* case.

As previously mentioned, questions of territorial restrictions probably do not materially affect a large segment of the trademark franchise industry (*e.g.* fast food franchises, motel franchises, or other established location retail establishments are not affected to a great extent). In franchise operations where closed territories are desirable, the use of the "area of primary responsibility" concept may provide some measure of control over wandering franchisees, particularly where the franchisees neglect or otherwise fail to fulfill their responsibilities in their assigned areas. The

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<sup>55</sup> 338 U.S. 350 (1949).

<sup>56</sup> 341 U.S. 593 (1951).

<sup>57</sup> 392 U.S. 194 (1967).

<sup>58</sup> CCH Trade Cas., ¶ 73,833 (1972).

terms of such a covenant, generally provides that the franchisee will use his best efforts to represent the franchisor and develop the franchise in the assigned area. The covenant does not expressly prohibit the franchisee from selling outside the area assigned, but neglect of the franchise operation in the territory of primary responsibility for the purpose of pursuing business in other areas may be the basis for termination of the franchise agreement. Such covenants may be acceptable so long as they are legitimately used as part of a program to develop the franchise product or service.<sup>59</sup> Of course, the covenant cannot be used for the principal purpose of accomplishing effectively closed territory arrangements by the use of threats, unwritten understandings or other misuse. The Federal Trade Commission in a recent consent decree permitted a defendant to designate geographic areas within which a "distributor may devote his best efforts to the area so designated . . . or to represent (defendant) in the area."<sup>60</sup>

*Restrictions on Goods and Services  
Purchased and Sold By Franchisees*

Franchisors often, with certain justification, take the position that it is necessary for them to exercise some control over the products or services offered by their franchisees as well as the equipment, supplies, and even the services, purchased by franchisees in connection with the operation of the franchise. There are legitimate reasons for some restrictions and the courts have upheld such valid restrictions. However, many of the foregoing restrictions are generally considered as incident to tying (where a seller agrees to sell or lease one desirable product on the condition that the buyer also purchase another "tied" product) or as evidence of exclusive dealing arrangements which can be illegal under the Clayton Act,<sup>61</sup> the Sherman Act,<sup>62</sup> or the Federal Trade Commission Act.<sup>63</sup>

Both the Sherman Act and the Clayton Act prohibit tying

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<sup>59</sup> See *United States v. Rudolph Wurlitzer Corp.*, CCH Trade Cas., ¶ 69,011 (W.D.N.Y. 1958).

<sup>60</sup> See *United States v. Snap-on Tools Corp.*, CCH Trade Reg. Reports, ¶ 15,546 (FTC Docket No. 7116, 1961); *United States v. Philco Corp.*, CCH Trade Cas., ¶ 68,409 (E.D. Pa. 1956).

<sup>61</sup> 15 U.S.C. § 1 (1970).

<sup>62</sup> 16 U.S.C. § 14 (1970).

<sup>63</sup> 15 U.S.C. § 45 (1970).

arrangements. The Sherman Act prohibits every contract, combination, or conspiracy in restraint of trade; but it has been interpreted to apply only to unreasonable restraints of trade,<sup>64</sup> and not every restraint, since theoretically every contract is a restraint of trade. In cases where a trademark or trademark franchise is involved in a direct or indirect tying arrangement, the first question is whether the restrictions are illegal *per se* and, if not, then whether the restrictions are reasonably ancillary to a legitimate intent to protect the goodwill or integrity of the trademark. *Northern Pacific Railroad Co. v. United States*<sup>65</sup> and several of the cases following *Northern Pacific* discussed *infra*, illustrate several arrangements which were held to be tying arrangements where a trademark was not involved.

In *Northern Pacific*, the Supreme Court held that under the Sherman Act, tying arrangements are *per se* illegal when certain prerequisites discussed *infra*, are met. In the *Northern Pacific* case the tying product was a lease on railroad property and the tied product was use of the services of the railroad. The Court indicated that the prerequisites to a finding of *per se* illegality are: (1) "sufficient economic power to impose an appreciable restraint on free competition in the tied product," and (2) "a not insubstantial amount of interstate commerce affected thereby."<sup>66</sup> The *Northern Pacific* case has generally been interpreted to permit certain restraints which are reasonably ancillary to a legitimate business purpose. In *Fortner Enterprises, Inc. v. United States Steel Corp.*,<sup>67</sup> the Supreme Court reiterated its *per se* rule in connection with tying agreements as stated in *Northern Pacific*, saying it applies "at least when the prerequisites are met."<sup>68</sup> The Court then broadened the coverage of the Sherman Act with respect to tying arrangements by holding that even when the prerequisites are not met, so there is no question of *per se* illegality, Section 1 can be violated by a tying arrangement if the restraint is unreasonable. However, in *Fortner*, the Court also noted that the existence of a legitimate business purpose and the lack of competitive advantage may be adequate defenses to a Section 1 claim of tying

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<sup>64</sup> See *Standard Oil of New Jersey v. United States*, 221 U.S. 1 (1911).

<sup>65</sup> 356 U.S. 1 (1958).

<sup>66</sup> *Id.* at 7.

<sup>67</sup> 394 U.S. 495 (1969).

<sup>68</sup> *Id.* at 498.

where the arrangement is not *per se* illegal and the circumstances support the defenses.<sup>69</sup>

In trademark franchising arrangements where the franchisee operates under the name, and assumes the identity of the franchisor, the franchisor will generally find it desirable to control the types and lines of goods the franchisee sells and may attempt to justify the restrictions on the basis of the quality control requirements imposed by the Lanham Act with respect to the trademark. In the petroleum industry, for example, it is common for the franchisor to lease the franchise premises to the franchisee and to supply the franchisee-dealer with his principal commodities. The lease is usually for a short period of time so that the Sword of Damocles forever hangs over the head of the franchisee. This provides significant leverage for the franchisor in his product sales to the franchisee.<sup>70</sup> In *Atlantic Refining Co. v. Federal Trade Commission*,<sup>71</sup> the Supreme Court found that as part of its franchise program Atlantic promoted the purchase of Goodyear tires, batteries and accessories by the franchisee so that the Goodyear items would be handled to the exclusion of all others. In return, Goodyear paid Atlantic, the franchisor here, a commission based on sales of the products to the Atlantic franchised outlets. Atlantic did not expressly argue that the plan was necessary to protect the goodwill of its trademark or franchise program but did argue that it was necessary for its stations to carry a full line of tires, batteries and accessories to stay competitive. The Court found the contract was not a "tying arrangement" but that "the central competitive characteristics" of the plan were the same as a tie. The plan was held to be illegal since (1) a franchisor received a commission for sponsorship, (2) the franchisor occupied and exercised a dominant position with respect to the franchisee and (3) a substantial amount of commerce was involved.

It can be argued that while the specific arrangement in *Atlantic* was not legal, the decision there does not automatically make all arrangements, where a franchisor requires franchisees to sell only certain products, illegal. For example, if the franchisor required

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<sup>69</sup> *Id.* at 506.

<sup>70</sup> *Chazin v. Gulf Oil Corp.*, 419 F.2d 396 (3d Cir. 1969).

<sup>71</sup> 381 U.S. 357 (1965).



a franchisee doing business under the franchisor's trademark to carry only tires, batteries and accessories bearing the franchised trademark, to the exclusion of other goods, then it can at least be argued that the trademark is related to the business purpose of the franchise. That is, a franchisee doing business under the trademark and style of business of the franchisor should not confuse the public by offering goods bearing other trademarks.

In *Federal Trade Commission v. Brown Shoe Co.*,<sup>72</sup> the Federal Trade Commission challenged a franchise where Brown provided franchisees a "carrot" in the form of a plan whereby Brown furnished services (*i.e.*, architectural assistance, signs, forms, group insurance and other benefits) to independent retailers or franchisees who would agree to concentrate their business within the grade and price lines of Brown, and also agree not to handle competing lines of shoes. The dealers or franchisees continued to do business under their own name, so the importance of the program in preserving Brown's goodwill was not at issue even though the dealers handled Brown trademarked shoes. The Supreme Court found that since the action was brought by the Federal Trade Commission under Section 5 of the Federal Trade Commission Act,<sup>73</sup> the FTC need prove only "incipient violation"<sup>74</sup> or restraint, without proof that the restraints amounted to an outright violation of the Clayton Act or any other provisions of the antitrust laws.

In *Fortner*,<sup>75</sup> United States Steel offered special financing covering not only houses to be sold by United States Steel, but also, land and the cost of development to the real estate developer, Fortner. The financing terms offered by United States Steel were better than those generally available elsewhere and were offered on the condition that Fortner purchase all of the houses to be constructed in the development site from United States Steel. The Court found that there was not just one product involved and that the second product, the financing, could be a "tying" product. However, the Court did not determine that the position of United States Steel in the financing market was sufficient to

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<sup>72</sup> 384 U.S. 316 (1966).

<sup>73</sup> 15 U.S.C. § 45 (1970).

<sup>74</sup> Fed. Trade Comm'n v. Brown Shoe Co., 384 U.S. 316, 320 (1966).

<sup>75</sup> Fortner Enterprises v. United States Steel, 452 F.2d 1095 (6th Cir. 1972).

constitute a restraint of trade in violation of the Sherman Act, but remanded for a determination at trial.<sup>76</sup>

With respect to franchises which extend beyond the mere purchase and resale of trademarked products, (*e.g.* the trademark franchise arrangement where the franchise extends to licensing of an entire business method or program) it at first glance seems logical that the franchisor should have a certain degree of latitude to restrict the goods offered for sale at the franchise location in order to protect the uniformity of services and goods offered, as they directly affect the goodwill of the franchise program and the integrity of the associated trademarks. However, such restrictions can constitute a restraint of trade, so the franchisor must be ready to defend these controls. In analysis of trademark franchise arrangements where the franchisee does business under the trademark and style of the franchisor, it is useful to divide the goods or services offered to franchise locations into categories. Category 1 includes goods used in operation of the franchise location which the retail customer or franchise location customer does not receive directly from the franchisee, and in most cases does not even see and is thus unable to identify the source or origin of the goods or to associate the indicated source or origin with the trademark franchise operation. Such items may include equipment used in operation of the franchise location, paper products distributed at the franchise location in connection with the franchised products, such as food, where even though they may bear the trademark of the franchisor in accordance with the franchise program the customer cannot identify the manufacturer. Category 2 includes those items or goods where the customer is able to determine the source or origin of the goods and associate the goods with the trademark franchise operation. In a fast food operation, for example, such items include the trademarked products actually offered for sale at the location. One primary question involved in restraints on trademark franchisees is the extent to which the franchisor can restrict the franchisee stocking, selling or using Category 1 or Category 2 items without the restraint constituting an illegal tying or exclusive dealing arrangement.<sup>77</sup>

The applicability of the Sherman Act and the Clayton Act to

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<sup>76</sup> *Id.*

<sup>77</sup> 15 U.S.C. § 14 (1970) and 15 U.S.C. § 1 (1970).

trademark franchise arrangements and particularly to "tying" arrangements have been considered on several occasions, as discussed hereinafter, with differing results. The differences can, at least in part, be distinguished by the facts of the case. In *Susser v. Carvel*,<sup>78</sup> a franchise case, the court expressly recognized that in compelling circumstances, the protection of goodwill, as embodied in a valuable trademark, may justify an otherwise invalid arrangement. The reference to protection of trademark goodwill is, of course, to the Lanham Act.<sup>79</sup> In *Susser*, the Court of Appeals recognized that there are clearly situations where tying the purchase of supplies to a trademark license could constitute a *per se* violation of the Sherman Act<sup>80</sup> and that the trademark franchise program in *Susser* was a tying product within the meaning of the Sherman Act. However, the court also found that not all trademark tying arrangements are *per se* violations.<sup>81</sup> The court made an express determination that under the circumstances in *Susser*, a franchisor could specify sources of supply to be used in manufacturing the trademarked product (the mix and ingredients for processing ice cream), to protect the integrity of the product and trademark. This in effect approved franchisor imposed restraints on purchase of Category 1 items where such restraints can be justified as reasonably necessary for the protection of quality and goodwill of the trademark.<sup>82</sup> It should also be noted that the court found that the trademark was displayed on only about 250 out of a total of 125,000 retail outlets for ice cream within the relevant market area; in these circumstances the trademark did not provide market dominance so that the restraint was not *per se* illegal.

In *Susser*, the court also held that it was not precluded from applying a flexible standard for exclusive dealing arrangements with respect to the franchisors' requirements that franchise dealers deal only with trademarked products or franchisor approved products, so that a uniform line of products would be offered at every retail outlet.<sup>83</sup> This finding can be interpreted to approve

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<sup>78</sup> 332 F.2d 505 (2d Cir. 1964).

<sup>79</sup> 15 U.S.C. § 1064(e) (1970), 60 Stat. 433 (1946).

<sup>80</sup> *Susser v. Carvel Corp.*, 332 F.2d 505, 513 (2d Cir. 1964).

<sup>81</sup> *Id.* at 512.

<sup>82</sup> *Id.* at 519.

<sup>83</sup> *Id.* at 513.

restraints on franchisees with respect to Category 2 items so long as certain prerequisites are met. Specifically, the court found that the franchisor could prohibit franchisees from selling hamburgers or Christmas trees through the franchised outlets. In reaching this conclusion, the court noted that in *Tampa Electric Co. v. Nashville Coal Co.*,<sup>84</sup> the Supreme Court had departed from its more rigorous and inflexible rule established in *Standard Oil Co. of California v. United States*,<sup>85</sup> with respect to requirement contracts. On this basis the court found that the requirement that only Carved products be sold at Carvel outlets is supported by the reasonably ancillary business purpose that the public identify each Carvel outlet as one of a chain that offers identical products with a uniform standard of quality.

The potential for conflict between the Lanham Act policing requirement and the antitrust laws was considered in *Siegel v. Chicken Delight*.<sup>86</sup> The district court found that as a matter of law a tying arrangement existed where Chicken Delight made use of an admittedly unique registered trademark combined with its ability to impose tying requirements. In *Siegel* the franchise arrangements provided that the franchisee would purchase all equipment, paper products, mix, etc. from the franchisor. No royalty was charged on gross sales, the franchisor relying exclusively on profits from the paper products, etc. sold to the franchisee for his profit. The court found that the only justification for the purchasing agreement involved in *Siegel* would be that the products the franchisor required the franchisee to purchase were necessary for protection of quality of the product, and that in this case the requisite necessity for protection of quality did not exist. The court found this was particularly true of the paper products since specifications could be readily established and the paper products could be purchased from different sources without effecting uniformity from outlet to outlet. The decision in the *Siegel* case was upheld by the Ninth Circuit Court of Appeals in *Siegel v. Chicken Delight, Inc.*<sup>87</sup> The appellate court sustained the trial court in finding that a trademark license may be a tying item because the

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<sup>84</sup> 365 U.S. 320 (1961).

<sup>85</sup> 337 U.S. 293 (1949).

<sup>86</sup> 311 F.Supp. 847 (N.D. Cal. 1970).

<sup>87</sup> 448 F.2d 43 (9th Cir. 1971) *cert. denied*, —U.S.— (1972).

rule governing tying arrangements is designed to strike not at mere coupling of physically separable objects, but rather at the use of a dominant desired product to compel the purchase of a second distinct commodity. Therefore, the court found a trademark may not be used to tie other products, such as equipment and paper products, which can be easily described in specifications and are not necessary for maintenance of the quality of the trademark.

*Siegel* deals primarily with questions involving the franchisor's restriction on purchase of Category 1 supplies and not with questions of franchisor's restriction on Category 2 products to be offered for sale at the franchise location. It should be noted that *Susser* dealt with both restrictions in the purchase of Category 1 raw materials and restrictions on the Category 2 products to be offered for sale at retail. The *Susser* case specifically approved the Category 1 restrictions in certain cases, for example, where the goods could not be adequately specified, contrary to the situation in *Siegel*. The court in *Susser* further approved the restrictions on Category 2 goods on the basis of uniformity of the franchise outlet, a question which was not considered in *Siegel*. From the foregoing, it could be concluded that franchisor restrictions on Category 2 goods offered for sale at retail, approved in *Susser*, were not affected by *Siegel*, and the franchisor may be free to restrain the products or services offered from franchised outlets doing business under the name and style of the franchisor.

The Federal Trade Commission is also concerned with franchise restrictions and in its *Ad Hoc Committee Report on Franchising*, the Committee stated:

A mere desire on the part of the franchisor to not have his trademark product associated with other products, particularly those of competitors, would seem to be difficult to justify in the ordinary case for the alleged purpose of protecting the quality, uniformity or image of the trademarked product. This would be particularly true of those franchise licensing arrangements in which the franchisee maintains his own identity and trade-name, as opposed to the franchisee who does business under the franchisor's name.

Similarly the designation of a particular supplier from whom associated products (for example, parts, ingredients or food) must be purchased, or the reservation of such sales to the fran-

chisor, again appear to be permissible under the present state of the law only if the associated products were essentially connected with the operation of the trademark products or essential for the maintenance of its quality and this fact could not be achieved by specifications.

On the other hand, if the franchise extends beyond the mere sale of a trademark product and encompasses the licensing of an entire business embracing a specific service or an overall format or design of operation, the allowable justification for these restrictions is somewhat broader. However, even in these franchise arrangements there is little doubt that the reasonableness of any restrictions imposed on this type of franchise would be strictly scrutinized and construed.<sup>88</sup>

The report further recognizes that an entirely different question is presented if the franchise label is used solely for the purpose of establishing a group of captive dealers.

After publication of the *Ad Hoc Committee Report on Franchising*, the Federal Trade Commission staff filed a proposed Complaint and Consent Order<sup>89</sup> against Gamble-Skogmo, in which the Commission charged that Gamble was requiring its Mode-O-Day franchisees to purchase and sell only products manufactured, sold or supplied by Gamble. The complaint also alleged price fixing. The proposed Consent Order prohibits these practices and would require Gamble to notify its franchisees that they are free to obtain merchandise of the type customarily sold in women's and children's ready-to-wear stores from any source and sell it in the Mode-O-Day shops, so long as the goods are identified as non-Mode-O-Day. Initially, it would appear that the Federal Trade Commission proceeding with respect to the *Mode-O-Day* case may cast some doubt on statements of the *Ad Hoc Committee Report* approving the validity of franchisor restrictions on products offered for sale at retail by franchisees. However, such a conclusion is clouded by the facts in the case. Specifically, Mode-O-Day shops were selling products with labels which were not associated directly with the franchisor Gamble-Skogmo, so the Consent Order may have been based on the fact that the arrangement fell within the exception noted, *infra*, in the Committee

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<sup>88</sup> FTC, REPORT OF AD HOC COMMITTEE ON FRANCHISING, June 2, 1969, at 32.

<sup>89</sup> Fed. Trade Comm'n v. Gamble-Skogmo, Inc., FTC Docket No. CE1-0184, May 3, 1970.

Report for franchises used solely for establishment of captive dealers. Also, the practices of the franchisor allegedly included price fixing at the franchisee level and provided the Federal Trade Commission with an adequate basis for broadened remedial provision.

Other cases dealing with restrictions on goods to be offered for sale by franchisees are of some interest in this matter and should be mentioned. In *Miller Motors, Inc. v. Ford Motor Company*,<sup>90</sup> the trial court found no antitrust violation in the use of a dealer arrangement requiring a Lincoln-Mercury dealer "to maintain a stock of genuine Mercury parts and approved accessories of an assortment reasonably comparable to current demand." The court expressly noted, with approval, that this agreement did not prevent the dealer from using or dealing in parts made by others since the pressures to stock Ford parts are legitimate under the circumstances and did not amount to an implied agreement not to deal in the goods or commodities of other suppliers.

In *Baker v. Simmons Company*<sup>91</sup> it was determined that an alleged "tying arrangement" which required hotels and motels displaying a mattress company's trademark to use that brand of mattresses exclusively, was pursuant to a legitimate purpose and was valid.

Thus, it would appear that certain restrictions in the nature of tying arrangements are permissible under the Sherman Act, the Clayton Act, and the Federal Trade Commission Act where a trademark is involved, but that such restrictions must be very carefully supported and justified as reasonably ancillary to a legitimate business purpose, the protection of the goodwill of the trademark, or some other equally meritorious reason or purpose. From the foregoing it can also be concluded that a franchisor has some right to limit the goods or services offered by his licensed franchisee when the franchisee adopts the style, format, and methods of the franchisor and operates under the franchisor's name, so that customers of the franchise location attribute the goods and services offered by the franchisee to the franchisor. But the current judicial attitude toward restrictions in distribution of goods is not congenial. It can also be concluded that the more

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<sup>90</sup> 252 F.2d 441 (4th Cir. 1958).

<sup>91</sup> 307 F.2d 458 (1st Cir. 1962).

strictly the franchisor enforces its franchise, the more latitude available for imposition of restrictions. However, even if all franchisees follow the prescribed uniform program with uniform business procedures and operating procedures, every restraint imposed must still be justified on a case by case, item by item, basis.

### *Exclusive Dealing*

Franchisors generally engage in arrangements susceptible to allegations of illegal tying but may, from time to time, find it to their advantage to use exclusive dealing arrangements, or other restraints, with respect to sources of supply of raw materials or supplies which franchisees normally purchase in connection with the franchise operation. Restraints in the nature of exclusive dealing arrangements are usually invoked with respect to materials used in the manufacture or sale of the trademarked item and such restrictions are usually justified in connection with a trademark as a quality control measure. While many times the franchise based restraints are limited to purchase of certain materials from approved sources, it is also true that in some cases the franchisor does not overlook the opportunity to make a substantial profit from the sale of the trademarked item or the ingredients or accessories used in producing the trademarked item.

While a customer, acting individually may elect to purchase his full requirements from a single supplier, it may be illegal for that supplier and the customer to agree that the customer will not purchase elsewhere. Likewise it may be illegal for the customer to agree with other purchasers of like commodities, who are very likely his competitors, that they will all patronize, or refuse to patronize, a particular supplier. The exclusive dealing arrangement, whether an outright contract or a covenant in a license agreement, may turn out to be a contract or a combination, or conspiracy in restraint of trade in violation of Section 1 of the Sherman Act. Where the restraint takes the form of an agreement in which the franchisee agrees that he will not use or deal in the goods or wares of competitors of the franchisor, rather than a simple tying arrangement supported by the franchise agreement, there may be a violation of Section 3 of the Clayton Act. *Standard*



*Oil Co. of California v. United States*,<sup>92</sup> was concerned with contracts obligating service stations to take their full gasoline requirements from Standard Oil. The contracts covered 16% of the retail outlets in the "Western Area." Standard Oil accounted for 23% of the total gallons of gasoline sold in this area. The Court in holding the arrangements to be in violation of Section 3 apparently based the decision on a rule which seemed to make legality turn almost entirely on the percentage of the relevant market foreclosed by virtue of the exclusive dealing arrangement. In *Tampa Electric Co. v. Nashville Coal Co.*,<sup>93</sup> the Supreme Court applied a different test from that relied upon in *Standard*. A foreclosure of \$128 million of coal covered by a utility's twenty-year requirements contract was held insufficient to make the contract illegal. While only a 0.77% share of the market was foreclosed, the Court did not rest on a holding that the share was insubstantial but, rather, stressed that it was necessary "to weigh the probable effect of the contract on the relevant area of effective competition . . . and the probable immediate and future effects which pre-emption of that share of the market might have on effective competition therein." In another approval in *Federal Trade Commission v. Brown Shoe Co.*,<sup>94</sup> the Court adopted an approach which under Section 5 of the Federal Trade Commission Act prohibits any exclusive dealing which effectively forecloses competitors from "a significant number" of outlets.

In the case of exclusive dealing arrangements imposed on trademark franchisees, where there is no question of *per se* illegality so that legality of the restraints is decided by whether the restrictions are ancillary to a legitimate business purpose. A trademark license cannot, however, be merely a device to avoid what would otherwise be violations of the antitrust laws.

#### CONCLUSION

Thus, except for *per se* violations, the legality of restraints imposed in connection with any particular franchise arrangement must be judged in view of the facts and circumstances surrounding the franchise system.

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<sup>92</sup> 337 U.S. 293 (1949).

<sup>93</sup> 365 U.S. 320 (1961).

<sup>94</sup> 384 U.S. 316 (1966).

While the Lanham Act gives no *carte blanche* exemptions from the antitrust laws, there is in some cases reason to conclude that the admonition of the Lanham Act requiring maintenance of trademark integrity does authorize certain restrictive covenants which, while not *per se* illegal, would otherwise be deemed illegal restraints of trade and may be effective to authorize in certain cases, exclusive dealing, tying, or territorial restraints. While every situation is different, the apparent overall rule applicable in most cases is that any leverage, trademark or other, which a franchisor exerts with respect to his franchisees must be used with the utmost caution and judged as to its legitimate business purpose.